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SECTION 303 STOCK REDEMPTIONS BY CLOSELY HELD CORPORATIONS

*Dean L. Overman**

I. Introduction

When a corporation redeems its stock, its stockholders receive a form of distribution. Whether the redemption constitutes a sale of the stock taxable to the stockholders as a capital gain or a distribution of property taxable as a dividend has been the subject of considerable litigation. Generally, any redemption will be treated as a distribution and taxed as a dividend unless it qualifies under one of the exceptions set forth in §§ 302(a), 302(b), 303 or 331 of the Internal Revenue Code (hereinafter cited as Code).¹

Section 303 of the Code is specifically designed to facilitate financing the estate tax of estates consisting largely of stock in a closely held corporation and thus, under certain circumstances, to prevent the enforced sale of a business.² This article discusses the basic requirements of § 303 and the problems involved in utilizing it, especially problems posed by the accumulated earnings tax of § 531.

II. General Discussion of § 303

Prior to the Revenue Act of 1950, an estate consisting largely of stock in a closely held corporation faced difficult problems. If the estate had insufficient assets to pay death taxes and administration expenses, the executor had to sell some or all of the stock to pay the estate's obligations. Since there was rarely a market for a closely held corporation's stock, the corporation itself was often the only available purchaser. If the sale of the estate's stock to the corporation did not result in a meaningful reduction in the estate's proportionate interest in the corporation, the consideration received by the estate was taxable as a dividend. Accordingly, the estate often had to dispose of its entire stock interest in a closely held corporation.

Section 115(g)(3) of the Revenue Act of 1950 treated a redemption of stock to pay death taxes as a sale of the redeemed stock. This section and its successor, § 303 of the 1954 Code, were enacted to alleviate some of the burdens of financing death taxes for estates consisting mainly of stock in a closely held corporation.

Section 303 allows capital gains treatment for amounts received as a result of a corporation's redemption of stock from the estate of a deceased stockholder and also from the beneficiary of the estate, provided the stock has been included in the gross estate of the decedent. If the § 303 conditions are met, the stock

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1 See C. MCCARTHY ET AL., *THE FEDERAL INCOME TAX*, 652 (2d ed. 1971) [hereinafter cited as *McCarthy*].

2 See purpose of § 115(g)(3) of 1939 Code, the predecessor to § 303, as set forth in H. R. REP. NO. 2319, 81st Cong., 2d Sess. 1950-2 CUM. BULL. 380, 427.

redemption from a deceased stockholder will be treated as an exchange without dividend consequences, even though the redemption would otherwise have been taxed as a dividend under § 302. The amount distributed is treated as payment for the redeemed stock. The redemption normally results in little gain, since the basis of the stock to the estate or beneficiary is its value on the date of the decedent's death³ (or on the alternate valuation date) and the redeeming corporation normally distributes the same amount for the stock. Section 303 thus provides a unique opportunity to distribute corporate assets with little or no tax.

A. Limitation on Size of Distribution

The special relief of § 303 is limited to an amount which does not exceed the sum of the federal and state death taxes (including interest) plus the funeral and administrative expenses allowable as deductions under § 2053 in computing the federal estate tax.⁴ If the death taxes and funeral and administrative expenses are incurred, the redemption proceeds need not actually be used to pay them. The appropriate amount of taxes and interest is the amount as finally determined for federal estate tax purposes, not merely the amount of taxes determined on the original return.

Ordinary income may be involved to the extent that a distribution in redemption of qualifying stock exceeds the total of death taxes and funeral and administration expenses. The excess will probably receive dividend treatment unless the redemption qualifies for one of the § 302 exceptions. In determining the amount of a distribution, Treas. Reg. § 1.303-2(g) makes it clear that *all* redemption distributions made within the statutory period are included without regard to whether any such distribution would be treated as a dividend were it not for § 303. The use of the plural "distributions" in Treas. Reg. § 1.303-2(g) indicates that an amount need not be distributed in a single redemption in order to qualify under § 303. Each distribution in redemption of stock within the statutory period qualifies.⁵

Section 303 does not specifically limit the number of shares which may be redeemed. If the corporation redeems a disproportionately large number of shares in comparison to the amount distributed, the Service will not recognize the total basis of the actual number of redeemed shares in determining the gain or loss. Rather, the total number of shares deemed sold will be the number of shares bearing the same ratio to the total outstanding number of shares as the purchase price bears to the fair market value of the corporation's net assets applicable to the shares redeemed at the time of redemption.⁶

B. Persons from Whom Stock May be Redeemed

As long as the redeemed stock has been included in the gross estate of the

³ INT. REV. CODE OF 1954, § 1014 [hereinafter cited as 1954 CODE].

⁴ 1954 CODE, § 303(a).

⁵ Rev. Rul. 67-425, 1967-2 CUM. BULL. 134.

⁶ See Rev. Rul. 55-592, 1955-2 CUM. BULL. 573. See also 9 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 9.107, at 334 (1969) [hereinafter cited as MERTENS]. The Service has set forth a slightly different formula in Rev. Rul. 56-513, 1956-2 CUM. BULL. 191, concerning a partial liquidation:

decendent,⁷ the stock need not be redeemed solely from the estate of the decedent.⁸ It may also be redeemed from any stockholder who received the stock as an heir or distributee,⁹ but not from a stockholder who acquired the stock from the executor in satisfaction of a specific monetary bequest¹⁰ or a person who acquired the stock by gift or purchase from any person to whom the stock passed from the decedent.¹¹

The redeemed stock may be voting or nonvoting, common or preferred. The redeeming stockholder need not have paid the taxes or administration expenses. For example, the redeeming stockholder may be the trustee of a marital deduction trust in a will providing that taxes and administration expenses shall be paid from a source other than the marital share.

C. Percentage of Stock Included in Gross Estate

In order to qualify for § 303 relief, the value of the redeemed stock must be either more than 35 percent of the value of the decedent's gross estate or more than 50 percent of the value of his taxable estate.¹² In applying the percentage requirements, the stock of two or more corporations may be treated as stock of a single corporation if the decedent owned more than 75 percent of each corporation's outstanding stock.¹³ The total value of all classes of stock includible in determining the value of the gross estate is taken into account.¹⁴

An executor must be careful, however, to include in his computation only

In determining the amount of the gain or loss, regardless of the actual number of shares surrendered for redemption by the stockholders, the total number of shares deemed to have been surrendered is that number which bears the same ratio to the total number of shares outstanding as the cash distributed bears to the total fair market value of the net assets of the corporation immediately prior to the distribution.

7 This requirement is of course satisfied if the decedent owned the stock at the time of his death. Stock will also qualify if it was included in the decedent's gross estate because it was held in joint tenancy with the decedent, because it was subject to the decedent's power of appointment or because it was transferred in contemplation of death. *See* B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 9.40 (3d ed. 1971).

8 If a loss is involved consideration must be given to § 267 which contains its own constructive ownership rules without reference to § 318 and provides that no deduction shall be allowed for losses arising from sales or exchanges between certain related taxpayers. *See* *Estate of Hanna v. Comm'r*, 320 F.2d 54 (6th Cir. 1963). *See also* Sommers, *Stock Redemption at Death: Does Section 267 Apply?*, N.Y.U. 23RD INST. ON FED. TAX 113 (1965).

9 For example, a legatee, donee of the decedent, surviving joint tenant, surviving spouse, taker in default of appointment, or a trustee of a trust created by the decedent.

10 If under a will an executor does not have discretionary power to distribute assets in kind, § 303 is inapplicable to a redemption of stock acquired in satisfaction of a bequest of an amount sufficient to utilize the marital deduction. *See* Rev. Rul. 70-297, 1970-1 CUM. BULL. 66.

11 *Treas. Reg. § 1.303-2(f)* (1964). In *U.S. v. Lake*, 406 F.2d 941 (5th Cir. 1969) the court held this regulation inapplicable where the "purchaser" actually paid the estate tax with the proceeds of the redemption, but the court also expressed some doubt concerning the validity of the regulation.

12 1954 CODE, § 303(b) (2) (A).

13 1954 CODE, § 303(b) (2) (B). *See* Rev. Rul. 69-594, 1969-2 CUM. BULL. 44, stating that this subsection provides the only method of lumping stock interests and that a corporation cannot reorganize to satisfy the 50 percent or 35 percent requirements after the date of death.

14 *See* *Treas. Reg. § 1.303-2(c) (2)* (1964), which contains the following example:

The gross estate of the decedent has a value of \$1,000,000, the taxable estate is \$700,000, and the sum of the death taxes and funeral and administration expenses is \$275,000. In-

the value of stock owned directly by the decedent at the time of his death.¹⁵ In *Estate of Otis E. Byrd*,¹⁶ the decedent at the time of his death owned stock in three corporations, but the value of the stock did not meet the 35 percent or the 50 percent requirement. The decedent, however, also owned a large percentage of stock in a fourth corporation which in turn owned stock of the other three corporations. The Tax Court refused to permit the decedent's estate to add its indirect ownership of stock (through the fourth corporation) in the three corporations to the value of its direct ownership of stock in those corporations.

D. Period for Distributions of Property

To qualify under § 303, the distribution in redemption must take place within the limitation period provided in § 6501(a) for the assessment of the federal estate tax or within 90 days after the expiration of such period.¹⁷ If a petition for redetermination of a deficiency is timely filed with the Tax Court, the distribution must occur within 60 days after the Tax Court's decision becomes final. The Service considers a distribution timely if made more than 60 days after the Tax Court's decision becomes final, provided it is made within 90 days after the expiration of the estate tax three year assessment period.¹⁸ The extension of the distribution period in the event a petition for redetermination is filed has reference only to bona fide contests in the Tax Court and does not apply to petitions filed solely for the purpose of extending the redemption period.¹⁹

The corporation need not distribute cash during the statutory redemption period. The Service has ruled that a distribution in redemption by a corporation

cluded in determining the gross estate of the decedent is stock of three corporations which, for federal estate tax purposes, is valued as follows:

Corporation A:	
Common stock	\$100,000
Preferred stock	100,000
Corporation B:	
Common stock	50,000
Preferred stock	350,000
Corporation C:	
Common stock	200,000

The stock of Corporation A and Corporation C included in the estate of the decedent constitutes all of the outstanding stock of both corporations. The stock of Corporation A and the stock of Corporation C, treated as the stock of a single corporation under section 303(b) (2) (B), has a value in excess of \$350,000 (35 percent of the gross estate or 50 percent of the taxable estate). Likewise, the stock of Corporation B has a value in excess of \$350,000. The distribution by one or more of the above corporations, within the period prescribed in section 303(b) (1), of amounts not exceeding, in the aggregate, \$275,000, in redemption of preferred stock or common stock of such corporation or corporations, will be treated as in full payment in exchange for the stock so redeemed.

15 Rev. Rul. 69-616, 1969-2 Cum. BULL. 45 states that for purposes of applying the percentage requirements stock owned by a pre-deceased wife of the decedent which was included in a marital deduction trust for the decedent may be considered a part of the stock owned directly by the decedent.

16 46 T.C. 25 (1966), *aff'd*, 388 F.2d 223 (5th Cir. 1967).

17 The Service has ruled that if redemptions are made over a ten year period in connection with an election under § 6166 to pay the estate tax in installments, only the distributions made within the three years and ninety days after the filing of the estate tax return (assuming filing on the date due) will qualify under § 303. See discussion *infra* concerning Rev. Rul. 72-188, 1972-1, Cum. BULL. 383.

18 Rev. Rul. 69-47, 1969-1 Cum. BULL. 94.

19 Treas. Reg. § 1.303-2(e) (1964).

of its own note within the three year tax assessment period was a timely distribution.²⁰ The Service reasoned that, even though all of the payments on the note would not be received during the statutory period, § 303 merely requires the distribution of property and that the definition of the term "property" includes a note. A note which constitutes an equity interest, however, may prohibit the use of § 303 if the payment on the note extends beyond the statutory period.²¹

III. Interrelating § 303 with Other Code Provisions

A. Section 302: Distributions in Redemption of Stock

When a redemption under § 302 is contemplated, consideration must be given to the wide scope of § 303. Where there are multiple distributions in redemption of stock, the initial distribution may be applied first against the amount allowed under § 303. Consequently, if a corporation redeems stock in a transaction qualifying as an exchange under § 302 and subsequently redeems stock in a transaction that must qualify under § 303 or not at all, the second redemption may be taxed as a dividend if the distribution in the first redemption used up the allowable amount. For example, suppose the estate of a decedent contains corporate stock valued at \$225,000 for federal estate tax purposes. Suppose further that the decedent's gross estate has a value of \$400,000, and his taxable estate a value of \$250,000 on which death taxes and funeral and administration expenses amount to \$112,500. After the first year of administration, one-third of the stock is distributed to the decedent's surviving spouse. Subsequently, the corporation redeems all of this stock for \$75,000, terminating the surviving spouse's interest in the corporation under § 302(b)(3). This redemption is applied against the \$112,500 amount and receives the full benefit of § 303. During the second year of administration, the corporation redeems another one-third of the stock included in the estate for \$75,000. Only \$37,500 of this distribution, however, qualifies for exchange treatment under § 303. Whether or not the remaining \$37,500 qualifies for exchange rather than distribution treatment depends on its status under other provisions of the Code.²²

B. Section 304

Under § 304, if one person controls two corporations and his stock in one corporation is purchased by the other, the transaction is treated as a redemption of stock by the acquiring corporation. The payment for the stock is taxable as a dividend unless exempt under § 302 or § 303. The specific provisions of § 303 take precedence over the provisions of § 304.²³ As long as the redeemed stock satisfies § 303, the distribution of an acquiring corporation under § 304 will receive exchange treatment. For purposes of meeting the percentage require-

20 Rev. Rul. 65-289, 1965-2 CUM. BULL. 86 and Rev. Rul. 67-425, 1967-2 CUM. BULL. 134.

21 For a discussion of this aspect, see Kahn, *Mandatory Buy-Out Agreements for Stock of Closely Held Corporations*, 68 MICH. L. REV. 1 (1969).

22 9 MERTENS, *supra* note 6, § 9.107 at 334.

23 Rev. Rul 55-592, 1955-2 CUM. BULL. 573.

ments of § 303, the Service looks to the stock of the acquiring corporation.²⁴ For example, if the estate of X controls A and B corporations (but owns less than 75 percent of each corporation) and A corporation meets the percentage requirements of § 303 while B corporation does not, A corporation can redeem the stock of B corporation from the estate of X and qualify for the nondividend benefits of § 303. However, B corporation cannot redeem the stock of A corporation and qualify under § 303.

C. Stock with Substituted Basis

If a decedent's estate acquires stock with a basis determined by the basis of stock which was included in the decedent's gross estate, the new stock may be redeemed under § 303 to the same extent that § 303 would have applied to the old stock's redemption. Accordingly, stock received in a spin-off, split up, reorganization,²⁵ liquidation²⁶ (where the estate is a qualified electing stockholder under § 333), nontaxable exchange of common for common or preferred for preferred, and nontaxable stock rights or dividends may qualify for the advantages of § 303. For example, if at the date of death a decedent owned 100 shares of corporation A's stock which was included in his gross estate, and corporation A subsequently merged with corporation B and exchanged its stock for stock in corporation B, the stock in corporation B could qualify for § 303 treatment.

D. Distribution of § 1245 and § 1250 Property

Although § 303 merely requires that property be distributed in a § 303 redemption, care should be taken as to certain kinds of depreciable property. A corporation distributing § 1245 property (depreciable personal property and certain depreciable real property, other than buildings and their structural components) in a § 303 redemption is required to recognize ordinary income to the extent the fair market value of the property distributed exceeds its adjusted basis. If a corporation distributes § 1250 property (all depreciable real property not included in § 1245) in a § 303 redemption, it must recognize ordinary income equal to the applicable percentage²⁷ of the lesser of the additional depreciation²⁸ attributable to such property or the excess of the amount realized on the transaction over the adjusted basis of such property.²⁹

24 Rev. Rul. 71-527, 1971-2 CUM. BULL. 174.

25 See Rev. Rul. 55-91, 1955-1 CUM. BULL. 364.

26 See Rev. Rul. 73-177, 1973-1 CUM. BULL. 168.

27 The applicable percentage for additional depreciation before 1970 is 100 percent if the disposition of the property takes place during the first 20 months following its acquisition and 100 percent minus one percent for each full month after the first 20 months. Under § 1250(a) (1) (C) the applicable percentage for depreciation allowed after 1969 is 100 percent except that certain special rules pertain to certain circumstances or property. For further discussion, see MCCARTHY, *supra* note 1, at 466.

28 If § 1250 property (other than rehabilitation in expenditure) is held for one year or less, "additional depreciation" is all allowable post 1963 depreciation. If § 1250 property is held for more than one year, additional depreciation is the allowable post 1963 depreciation permitted under any accelerated method over the allowable depreciation under the straight line method. See MCCARTHY, *supra* note 1, at 465.

29 For a more thorough discussion of § 1245 and § 1250 property, see Taft, *Considerations in Utilizing Section 303 of the 1954 Code*, 46 TAXES 52 (1968).

IV. Estate Planning Possibilities

A. Meeting Percentage Requirements

Although little flexibility may be available in determining the percentage of the decedent's ownership of stock in two or more corporations, some post death planning is available to an executor in determining the percentage value of the stock included in the decedent's estate.³⁰ For example, the amount of the gross estate or taxable estate, or the value of the included stock may be determined as of the estate tax alternate valuation date as provided in § 2032.³¹ If the stock's value increases in the six months following the decedent's death, on the alternate valuation date it may be a larger percentage of the gross estate. This may result in higher estate taxes, but the additional estate taxes may be offset by the opportunity for the corporation to distribute corporate assets with little or no tax consequences.

Another possibility an executor might employ in post death planning is reducing the size of the taxable estate. If the taxable estate is reduced, the included stock may meet the 50 percent requirement. One possibility is to deduct administration expenses on the federal estate tax return rather than on the estate's fiduciary income tax return.

Another planning possibility concerns the valuation of the stock. Since the value of the stock in a closely held corporation is normally open to question, the highest reasonable value can be placed on the stock to meet the percentage requirements. This may again result in increased estate taxes, but any increase must be weighed against the benefits derived from the § 303 redemption. A completely spurious value, however, cannot be placed on the stock to be redeemed. If the value of the stock is substantially uncertain, an executor might enter into a contingency or open end agreement with the corporation which provides not only for a revision of the stock value to reflect the value as finally determined upon the completion of the federal estate tax audit but also, in the event the percentage requirements are not met, a cancellation of the redemption and the return of the property distributed by the corporation.³²

B. Extension of Time for Payment of Estate Taxes

In planning § 303 redemptions, consideration should be given to § 6166 which provides for the payment of estate taxes in equal annual installments over a period from two to ten years. Interest on the deferred balance of the estate tax is payable at the rate of 4 percent. Because of the low interest rate an executor may decide against a § 303 redemption for the purpose of investing the

30 See Tiger, *How to Plan Stock Redemptions To Pay Estate Taxes—Problems of Section 303*, 24 J. TAXATION 92 (1966).

31 Treas. Reg. § 1.303-2(b) (1964). The Service has ruled that an executor can select the alternate valuation date even if the use of that date results in a higher estate tax than the use of the date of death value. See Rev. Rul. 55-333, 1955-1, CUM. BULL. 449.

32 See Niemann, *Essentials of Corporate Stock Redemption Under Sec. 303*, 1972 WIS. L. REV. 1153.

cash to be used to pay estate taxes.³³ The requirements for relief under this section are similar, although not identical,³⁴ to the requirements for relief under § 303, except that the deferral payments are limited to estate taxes attributable to closely held businesses. Under § 6166, the decedent's gross estate must include an interest in a closely held business which exceeds 35 percent of the value of the gross estate or 50 percent of the taxable estate. Section 6166(c)(3) defines an interest in a closely held business to include stock in a corporation carrying on a trade or business, if either 20 percent or more in value of the voting stock is included in determining the decedent's gross estate or the corporation has ten or fewer stockholders.

Although § 6166 may be used with a § 303 redemption, under § 6166(h) the estate tax installments are accelerated to the extent of funds received pursuant to the stock redemptions. If 50 percent or more of the stock is sold or otherwise disposed of, the extension of time ceases to apply and any unpaid portion of the estate tax may be demanded.

Revenue Ruling 72-188³⁵ illustrates the application of § 303 and § 6166 where stock in an estate is redeemed in each of ten consecutive years and an election is made to pay the estate tax attributable to the stock in ten equal installments. In that ruling the decedent died on September 1, 1966. His entire gross estate amounted to \$800,000 and contained 100 shares of stock in a corporation valued at \$500,000. \$125,000 of the \$200,000 estate tax was attributable to the corporation's stock. No petition for redetermination of the estate tax was filed with the Tax Court. The executor elected under § 6166 to pay \$125,000 of the estate tax in ten annual installments. On December 1, 1967, the due date for the portion of the estate tax not being paid in installments and for the first of the ten annual installments, the executor filed the estate tax return and paid \$87,500, of which \$75,000 represented the tax on the value of the estate not attributable to the stock of the corporation and \$12,500 represented the first installment on the tax attributable to the stock. In order to help the executor meet the estate tax liability, the corporation redeemed ten shares of its stock for \$50,000 on November 1, 1967, 1968, 1969, 1970, and 1971. It also agreed to redeem ten shares on November 1, 1972, 1973, 1974, 1975, and 1976.

The Service reasoned that although the limitation provided in § 303(a) would not be reached before the fifth redemption (the aggregate distributions would not exceed the estate tax alone until that time), the fifth redemption would occur at a time beyond the statutory period specified in § 303(b)(1)(A). Accordingly, irrespective of the amount of administration and funeral expenses, only the first four distributions in redemption of the stock would qualify under § 303. The Service also ruled that the estate tax installment payments would be

33 In addition, if there is a possibility that the value of the included stock may be substantially revised during the estate tax audit, an executor may file for an extension under § 6166 to avoid having to raise large funds to pay the tax in a single payment. See discussion in Kadish, *Section 303-Redemptions To Pay Death Taxes and Administrative Expenses: A Relief Provision Liberally Construed*, 18 CASE W. RES. L. REV. 895 (1967).

34 One of the differences between these sections is that unlike § 303 which permits a distribution in redemption after the filing of the federal estate tax return, an extension under § 6166 must be elected not later than the statutory period for filing the return.

35 1972-1 CUM. BULL. 383.

accelerated when 50 percent in value of the interest in the corporation was redeemed—the date of the sixth redemption.³⁶

C. *Avoiding the Accumulated Earnings Tax*

One of the most difficult problems facing a corporation contemplating a possible § 303 redemption concerns the accumulated earnings tax of § 531. In order to take advantage of § 303, a closely held corporation must of course have sufficient funds to finance the redemption. One of the easiest methods is simply to accumulate the corporation's earnings prior to the time of redemption. The accumulated earnings tax, however, may frustrate any such attempt at tax savings, since it appears in some respects to completely counteract the benefits of § 303.

In general, § 531 imposes a penalty tax on a corporation when its accumulated earnings and profits exceed \$100,000 and it retains earnings beyond the reasonable needs of its business. This section is specifically designed to impose an extra tax on corporations formed or availed of to avoid an income tax on their shareholders.

The Fourth Circuit's opinion in *Mountain State Steel Foundries, Inc. v. Comm'r*³⁷ provided some hope that §§ 303 and 531 would be construed together and the benefits of an accumulation for the purposes of a § 303 redemption would be obtained without the burdens of the accumulated earnings to discharge the indebtedness incurred for the redemption. In that case the corporate taxpayer first redeemed 50 percent of its outstanding stock and then accumulated earnings to discharge the indebtedness incurred for the redemption. The court held that the purchase of the stock served the corporate purpose of buying out the interests of a dissatisfied stockholder but cautioned that there could be situations where accumulation for a redemption would invoke the burdens of § 531. Although the redemption was not made pursuant to § 303, the court referred to § 303 to support its conclusion that an excess accumulation of earnings for purposes of a redemption was not alone sufficient for the assertion of § 531 penalties:

Congress finally acted in this field. Among other things, it specifically provided that a partial redemption of the shares held by an estate would be treated as a sale, not as a distribution of earnings, if the amount of the distribution did not exceed the estate's liabilities for estate and inheritance taxes, interest and funeral and administration expenses. When Congress specifically provided favorable tax treatment for such transactions and sought to encourage them to facilitate the administration of estates, it hardly could have intended to penalize the corporation for doing the favored act.³⁸

Subsequently, however, at least three cases have held that the accumulation of earnings to prospectively fund a § 303 redemption failed to meet the reasonable needs of the business test of § 533. The courts viewed these redemptions

³⁶ *Id.*

³⁷ 284 F.2d 737 (4th Cir. 1962).

³⁸ *Id.* at 745.

as serving the personal needs of the stockholders rather than the needs of the corporation. As the court said in *Youngs Rubber Corp. v. Comm'r*:³⁹

Petitioner loses sight of the requirement that the accumulation must be for the reasonable needs of its business, and not to provide the estate of its majority stockholder with sufficient funds to meet the various estate duties and other expenses. *Pelton Steel Casting Co. v. Commissioner*, 251 F.2d 278, aff'g 28 T.C. 153. This is not a case where a corporation makes provisions to buy out a dissident stockholder, or arranges to redeem the stock from the estates of the stockholders in the interest of corporate harmony.⁴⁰

The same language is repeated almost verbatim in *Kirlin Corp. v. Comm'r*⁴¹ and *Dickman Lumber Co. v. United States*.⁴² Each of these cases held that accumulations for § 303 redemptions were not for the reasonable needs of the business, but for the personal needs of the stockholders.

The Tax Reform Act of 1969 contains some relief from the *Youngs Rubber* line of decisions. Section 537 now provides that for taxable years ending after May 26, 1969, the "reasonable needs of the business" include amounts needed (or reasonably anticipated to be needed) to accomplish a § 303 redemption in the year of death and later years.

The regulations under § 537 clarify the statute in three significant respects:

(1) A corporation with stock having a substituted basis (as described above) may accumulate earnings for a § 303 redemption.⁴³

(2) When two or more corporations qualify to accumulate earnings for § 303 redemptions, each corporation may accumulate an amount which bears the same ratio to the amount described in § 303(a) as the fair market value of its included stock bears to the fair market value of all of the included stock of the corporations. If the particular facts and circumstances indicate that this allocation rule is not required, however, the rule may not be used. Thus, if an executor notifies the corporation that he intends to redeem the stock of any one of them under § 303, only the chosen corporation could accumulate earnings for the redemption.⁴⁴

(3) The fact that an accumulation has been made for the purposes of carrying out a § 303 redemption will not raise an inference that any prior year's accumulation exceeded the reasonable needs of the business. The reasonableness of an accumulation in a year prior to a § 303 redemption is to be determined upon the facts existing at the time of the accumulation.⁴⁵

Unfortunately, § 537 only provides protection in the year of death and for

39 21 CCH Tax Ct. Mem. ¶ 25,809 (1962), *aff'd*, 331 F.2d 12 (2d Cir. 1964).

40 *Id.* at p. 1600.

41 361 F.2d 818 (6th Cir. 1966).

42 65-1 U.S. Tax Cas. ¶ 9133 (D. Wash. 1964).

43 Treas. Reg. § 1.537-1(c) (2) (1959).

44 Treas. Reg. § 1.537-1(c) (3) (1959).

45 Treas. Reg. § 1.537-1(e) (3) (1959). The proposed regulations under § 537 contained the following "elder shareholder" rule which was stricken in the adopted regulations:

In fact, it may give rise to an inference that the accumulation was for the reasonable needs of the business in such prior year if, for example, the corporation was obligated by contract to effect a distribution to which Section 303 applies upon a shareholder's death and such shareholder is of advanced age so that death within the next few years is a substantial possibility and the redemption price is reasonably ascertainable.

Proposed Treas. Reg. § 1.537-1, 36 Fed. Reg. 14002 (1971).

later years since it covers only accumulations accruing *after* the death of the stockholder. The prospective accumulation of earnings before a stockholder's death is still governed by the *Youngs Rubber* line of cases. Congress appears to have reinforced the notion expressed in those cases that the accumulation of earnings in *anticipation* of a § 303 redemption in a year other than the year of death of a stockholder or a subsequent year is contrary to the reasonable business needs of the corporation.

One procedure for demonstrating a corporate purpose appears in *Emeloid Co. v. Comm'r.*⁴⁶ In that case the corporation purchased life insurance on its two principal stockholder-officers to protect the corporation against the loss of their key managerial skills and experience. Subsequently, a trust agreement was entered into whereby the two officers and their wives agreed to sell the stock of the first of the officers to die to the corporation. The proceeds of the life insurance policies were to be used to purchase this stock, thus providing for a continuity of harmonious management. The Third Circuit held that the sums borrowed by the corporation for the payment of premiums on the policies constituted "borrowed invested capital" within the meaning of the excess profits tax.

This opinion is now considered authority for two propositions: (1) accumulations for key man insurance serve a corporate purpose and (2) insurance to a stock redemption agreement may serve a corporate purpose.⁴⁷ A purchase of key man life insurance and subsequent use of some of the insurance proceeds to redeem part of the stock of the insured decedent stockholder should not invoke the burden of § 531. This is precisely what the corporation in *Emeloid* intended to do when it entered into the trust agreement. Indeed, the Third Circuit held that the trust agreement was merely implementing the original key man purposes for which the life insurance was first purchased.

In addition to the purchase of key man life insurance, two other techniques may be used to demonstrate a proper business purpose for prospective accumulations for § 303 redemptions. First, if life insurance is unavailable, the corporation could establish a cash reserve and self-insure for key men. Although no decision is on point, an accumulation of earnings for the purpose of self-insuring key men should be treated as a purchase of life insurance under the *Emeloid* decision. Second, the corporation may execute a stock purchase agreement which, if the facts so justify, recites that it is entered into to maintain harmony and prevent the family of a deceased stockholder from disrupting the operations of the corporation. Courts are apparently willing to uphold the redemption of stock from a dissenting minority stockholder as a reasonable business need.⁴⁸ The redemption of stock to prevent the family of a decedent minority stockholder from interfering with the policies of the business should be treated similarly. As

46 189 F.2d 230 (3d Cir. 1951).

47 See Washington, *Can Earnings Still Be Accumulated to Finance Section 303 Stock Redemptions?* 44 TAXES 43 (1966).

48 See *Gazette Publishing Co. v. Comm'r.*, 103 F. Supp. 779 (E.D. Ark. 1952). *Dill Manufacturing Co. v. Comm'r.*, 39 B.T.A. 1023 (1939). But see *Ted Bates & Co., Inc.*, 251 F.2d 278 (7th Cir. 1958), where the court held that the use of funds to redeem a portion of a majority stockholder's stock served a corporate purpose because it was done to increase the percentage of three stockholder-employees.

in the *Mountain State Steel* case,⁴⁹ the redemption distributions under the agreement should be paid out in installments evidenced by a bona fide debt instrument. Installment payments are preferable because a lump sum payment in redemption may create an inference of past excess accumulations.⁵⁰

V. Conclusion

Section 303 should not be overlooked in tax planning for closely held corporations. It presents an excellent opportunity for an estate or the heirs of a deceased stockholder to withdraw cash or property from the corporation without paying a dividend tax. Consideration must be given, however, to the relationship of § 303 to other provisions of the Code, especially the accumulated earnings tax of § 531.

⁴⁹ 284 F.2d 737 (4th Cir. 1962).

⁵⁰ See Grossman, *Section 531 Problems Including the Bardahl Formula* 45 TAXES 913 (1967).